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Explaining the Decline in Tax Effort

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The weakening of the government's fiscal position in 2002 and in 2003 underscores more than ever the urgency of arresting the undeterred contraction of the revenue effort of the national government which has slipped since the onset of the East Asian financial crisis from 19.4 percent of gross domestic product (GDP) in 1997 to 15.5 percent of GDP in 2001 and 13.9 percent in 2000. Although other countries in the region have likewise suffered a deterioration in their revenue effort since 1997/1998, the decline in these countries, with the exception of Malaysia, has not been as severe as that in the Philippines (Table 1).

Although nontax revenues dipped as well, the erosion of the revenue effort in the Philippines is largely due to the weakening of the tax effort as in the other countries in the region. Thus, overall tax effort in the Philippines plummeted by 3.5 percentage points from a peak of 17.0 percent of GDP in 1997 to 13.5 percent in 2001 (Figure 1). About two-thirds of the contraction (or 2.3 percentage points of GDP) is due to the reduction in Bureau of Internal Revenue (BIR) tax revenues while the remainder (or 1.2 percentage points of GDP) is attributable to the reduction in Bureau of Customs (BOC) revenues.

Table 1. Revenue and tax effort in ASEAN countries, 1996-2000 (Percent of GDP)

	1996	1997	1998	1999	2000
Total revenue					
Indonesia	17.0	18.1	12.6	17.9	15.9
Malaysia	23.3	23.5	20.0	19.7	18.3
Thailand	19.5	18.6	16.2	16.2	16.5
Philippines	18.9	19.4	17.4	16.1	15.6
Tax revenues					
Indonesia	14.7	16.5	11.8	16.6	14.5
Malaysia	19.4	19.8	16.7	16.0	14.3
Thailand	17.6	16.5	14.2	14.0	14.3
Philippines	16.9	17.0	15.6	14.5	13.9

Collections for all the major tax groups fell relative to GDP in 1997-2001. The biggest reductions were exhibited by the import duties, excise taxes, and income taxes. For instance, tariff revenues tumbled from 3.9 percent of GDP in 1997 to 2.6 percent of GDP in 2001. Collec-

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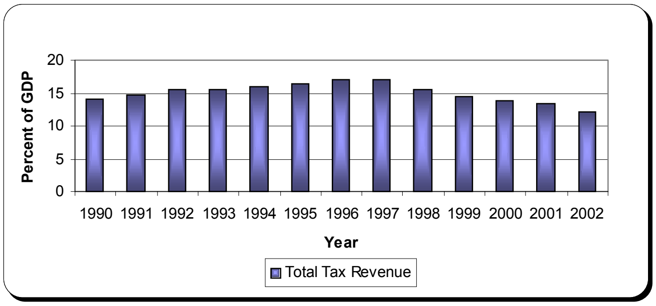
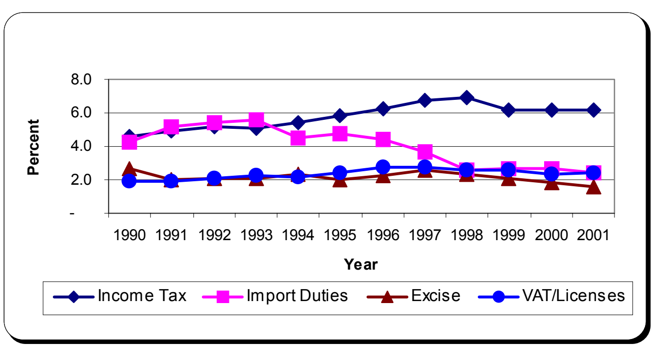
Figure 1. Overall tax effort



tions from excise taxes shrank from 2.6 percent to 1.6 percent of GDP, revenues from taxes on income and profits, from 6.8 percent to 6.1 percent of GDP while collections from value added and licenses, from 2.8 percent to 2.4 percent of GDP during the same period (Figure 2).

While the slide in nontax revenues is largely explained by the diminution in the income of the Bureau of Treasury following the decline in domestic interest rates, the reasons for the fall in tax revenues have been somewhat of a puzzle to many analysts. On the one hand, many believe that the slump in tax effort reflects the lack of political will to tackle tax evasion. On the other hand, some groups point out that changes in the structure of the economy during the period (e.g., economic recovery being led by lightly taxed sectors like agriculture and exports) partly explain the degeneration of tax effort. Still others note that some of the tax policy changes introduced in 1996/1997 under the umbrella of the Comprehensive Tax Reform Package (Box 1) may have resulted

Figure 2. Tax-to-GDP ratio, selected taxes, 1990-2001



in loss of revenue that was not compensated adequately by the expected revenue gains from provisions that were not legislated and therefore not implemented.

Table 2 shows the varying importance of each of these factors in explaining the decline in tax effort at the BIR and BOC in 1997-2001.[1] While the fall in BOC revenues account for over three-quarters of the overall contraction in tax effort between 1997 and 1998, BIR has since then emerged to be the dominant source of the flagging tax effort. The programmed reduction in tariff rates under the trade liberalization program of the government accounts for some 40-50 percent of the reduction in tax effort at the BOC in 1998-1999. Changes in the composition of imports (i.e., the shift away from dutiable imports) also adversely affected the BOC's tax take in those two years. A deterioration in the quality of customs administration was evident in 1998 but not in 1999-2001. Thus, almost all of the diminution in the BOC's tax effort in 2000 and 2001 was due to the lower tariff rates. On the average, BOC tax effort dipped by 0.33 percentage point of GDP every year between 1997 and 2001 due to the planned reduction in tariff rates.

The negative impact on revenues of lower import tariffs was compounded by weaknesses at the BIR which resulted in huge tax leakages even prior to 1997.[2] Higher tax evasion (relative to 1997) accounted for 98 percent

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[1] *In column 1 of Table 2, the change in the tax-to-GDP ratio for each year in 1998-2001 is always measured relative to 1997. For each of the major taxes, the contribution of the change in economic structure to the decline in tax effort was derived by estimating the amount of tax revenue that would have been collected if there were no changes in the composition of the economy relative to 1997 (i.e., if the tax base-to-GDP ratio was kept at the 1997 level). On the other hand, the contribution of the change in tax policy to the deterioration of tax effort was computed by estimating the amount of tax revenue that would have been collected if the effective tax rates that were prevailing in 1997 were applied to the current year's tax base. Meanwhile, the contribution of higher tax evasion was derived as a residual. That is, what cannot be explained by the first two factors was attributed to increased tax evasion.*

[2] *The Department of Finance (1998) estimated the total tax leakage in 1997 at 7.8 percent of GNP (with 7.2% of GDP due from the BIR and 0.6% of GNP due from the BOC).*

Box 1. The 1996/1997 Comprehensive Tax Reform Package

In 1996-1997, the government launched another round of tax reform under the umbrella of the Comprehensive Tax Reform Package. As originally designed, it was meant to (1) widen the tax base; (2) simplify the tax structure so as to minimize the tax evasion; and (3) make the system more elastic and easier to administer. While intended initially to be legislated as a comprehensive measure, it was actually passed into law in piecemeal fashion.

As a result, Republic Act (RA) 8184 which provided for the restructuring of the excise tax on petroleum products hand in hand with tariff restructuring in the sector was enacted into law in June 1996. Meanwhile, RA 8240 which reverted the excise tax on fermented liquor, distilled spirits and cigarettes back to the specific scheme from the *ad valorem* system took effect on January 1, 1997. On the other hand, RA 8241 (which also took effect on January 1, 1997) expanded the list of items that are exempted under the expanded value added tax (EVAT) to include printing, publication, importation or sale of books, newspapers, magazines, reviews or bulletins; operators of taxicabs, rent-a-car companies; operators of tourist buses; small radio and television broadcasting franchise grantees; sale of properties used for low-cost and socialized housing; and the lease of residential units with a monthly rental not exceeding P8,000 per month. Lastly, RA 8424 (otherwise known as the Tax Reform Act of 1997) was passed by Congress in 1997. It provided for (1) the phased reduction in the corporate income tax rate from 35 percent in 1997 to 32 percent from 2000 onwards; (2) the levy of a 2 percent minimum corporate income tax rate; (3) the adoption of the net operating loss carry forward (NOLCO); (4) accelerated depreciation using double declining balance or sum-of-the-years digits method; (5) cap on deductibility of travel and entertainment expense; (6) disallowance of the tax benefits of interest arbitrage; (7) introduction of a tax on fringe benefits; (8) reimposition of the final withholding tax on dividends although intercorporate dividends remain exempt; (9) levy of a final withholding tax of 7.5 percent on interest earned by residents on foreign currency deposits; (10) increase in the level of personal exemptions for the individual income tax; and (11) gradual reduction of the top marginal tax rate for the individual income tax from 35 percent in 1997 to 32 percent in 2000 onwards.

It should be emphasized that the various bills adopted by Congress deleted key proposed features of the tax reform package. In consequence, the overall impact of the Package on the revenue performance of the tax system has been negative. On the one hand, the broader coverage of the VAT under the expanded VAT (i.e., EVAT) improved VAT effort (albeit to a lesser degree than projected by government), with revenues from the VAT and selected tax on services (like other percentage taxes, tax on insurance premiums and franchise tax) rising from 2.2 percent of GDP in 1995 to 2.4 percent of GDP in 1997. On the other hand, while the adoption of specific rates for excise taxes was meant to guard against evasion, the move reduced the buoyancy of the tax system because the indexation provision that was part of the original proposal was not approved by Congress. In like manner, although the rationalization of fiscal incentives was an integral part of the Package when it was first conceived, the proposal has not been passed in Congress even as the key departments (Department of Finance, Department of Trade and Industry, National Economic and Development Authority, and Department of Budget and Management) continue to debate the design and coverage of tax incentive regimes.

Meanwhile, the provisions of RA 8424 relating to the corporate income tax were estimated to increase revenues. Not all of the expected gains in revenue, however, were realized on time because of the delays in the issuance of the regulations needed to implement said provisions. On the other hand, the revenue losses arising from the increase in personal exemptions for individual income tax payers were felt immediately.

and 54 percent of the reduction in BIR tax effort in 1998 and 1999. While some improvement in BIR tax administration was evident in 2000 (relative to the 1999 level but not relative to 1997), further weakening of the system was registered in 2001. In that year, the VAT as well as the tax on income and profits were the major sources of evasion.

On the other hand, the contribution of changes in tax policy to the collapse of BIR tax effort rose persistently in 1998-2001. In particular, 46 percent of the 2.3 percentage point decline in BIR tax effort between 1997-2001 was attributable to changes in tax policy (notably the reduction in effective tax rates for the income tax and the excise tax due to nonindexation), another 46 percent to increased evasion and only 7 percent to changes in economic structure. On the average, BIR tax effort declined by 0.26 percentage point of GDP every year between 1997 and 2001 due to the changes in tax structure brought about by the CTRP. It is also notable that, on the whole, the reduction in tax effort brought about by modifications in tax policy (specifically those due to the nonindexation of excise taxes) is not a one-time reduction but has been growing over time.

In sum, Table 2 suggests that tax evasion continues to be a major source of the leakage in revenues and that the situation appears to have worsened in 2001. However, it also indicates that weaknesses in tax structure (nonindexation of excise taxes and the lower effective income tax rates without compensating changes in other taxes) likewise contributed significantly to the decline in tax effort.

Table 2. Explaining the decline in tax effort[a]

	1998				1999			
	Economic Structure	**Tax Policy**	**Increased Evasion**	**Total**	**Economic Structure**	**Tax Policy**	**Increased Evasion**	**Total**
BIR	0.3	-0.3	-0.3	-0.3	-0.2	-0.5	-0.8	-1.5
% contribution	-84.4	85.9	98.4	100.0	16.0	30.4	53.6	100.0
Value added tax	0.0		-0.2	-0.2	0.0		-0.2	-0.2
Tax on income and profits	0.4	-0.1	-0.1	0.1	-0.1	-0.2	-0.4	-0.6
Excise taxes	-0.1	-0.1	0.0	-0.2	-0.1	-0.3	-0.1	-0.5
Other domestic taxes			0.0	0.0			-0.2	-0.2
BOC	-0.3	-0.4	-0.3	-1.1	-0.5	-0.5	0.0	-1.0
% contribution	28.6	39.0	32.4	100.0	47.0	49.0	4.0	100.0
Tax revenues	0.0	-0.7	-0.7	-1.4	-0.7	-0.9	-0.8	-2.5
%	2.2	50.0	47.8	100.0	28.4	37.8	33.8	100.0

	2000				2001			
	Economic Structure	**Tax Policy**	**Increased Evasion**	**Total**	**Economic Structure**	**Tax Policy**	**Increased Evasion**	**Total**
BIR	-0.8	-0.8	-0.4	-2.1	-0.2	-1.1	-1.1	-2.3
% contribution	38.8	40.8	20.4	100.0	7.3	46.5	46.2	100.0
Value added tax	0.0		-0.4	-0.4	0.0		-0.4	-0.4
Tax on income and profit	-0.7	-0.2	0.2	-0.6	0.0	-0.3	-0.3	-0.6
Excise taxes	-0.1	-0.7	0.1	-0.7	-0.2	-0.7	-0.1	-1.0
Other domestic taxes			-0.3	-0.3			-0.3	-0.3
BOC	0.0	-1.0	0.0	-1.0	-0.1	-1.3	0.1	-1.3
% contribution	3.9	98.1	-1.9	100.0	4.8	106.3	-11.1	100.0
Tax revenues	-0.8	-1.9	-0.4	-3.1	-0.2	-2.4	-0.9	-3.6
%	27.2	59.9	12.9	100.0	6.4	67.7	25.9	100.0

[a]Change in tax effort relative to 1997, measured as percent of GDP.

What can be done? Given this perspective, two pieces of legislation are urgently needed.

One is a need to amend RA 8240 so as to allow for the indexation of the excise taxes on tobacco and alcoholic products. While the fiscal authorities talk about the "restructuring of the excise taxes on distilled spirits and the indexation of the tax rates two years thereafter by the amount of cumulative inflation" in the Budget of Expenditures and Sources of Financing (BESF), it is not clear if such indexation is intended to apply to excise taxes on fermented liquor and cigarettes.[3] Moreover, the BESF is silent on the indexation of excise tax on petroleum products.

And *two* is a need to revisit proposals for the rationalization of fiscal incentives (Box 2). These proposals call for a shorter list of activities that would qualify for investment incentives and the adoption of an operative budget for tax expenditures pertaining to fiscal incentives. In addition, the BESF is also calling for the lifting of the present exemption of Asian utility vehicles from the excise tax on automobiles. Given the proximity of the 2004 election, moving these new tax measures through the legislative mill in their undiluted form will be a major challenge to

[3]With respect to alcoholic and tobacco products, the BESF only talks about the reclassification of products based on their current net retail price.

Box 2: Fiscal incentives

At present, there are some 150 laws that provide tax incentives to various industries and special interest groups. These are mainly in the form of tax credits and exemptions that have narrowed the tax base and increased the opportunities for tax avoidance, primarily because of the wider scope for discretion in the administration of the incentive system.

Fiscal incentives are wide ranging across activities and sectors and extend to various taxes. The most important of these are those that provide income tax holiday and exemption from import duties to selected industries through the Board of Investments (under the 1987 Revised Omnibus Investment Code) and to locators in special economic zones through the Philippine Export Zone Authority (PEZA). For example, export enterprises are exempted from customs duties and sales taxes on inputs and receive additional deductions for labor costs and tax credits for using domestic raw materials. Further incentives are granted to "pioneer" industries which introduce new products, use labor-intensive processes or produce more than 50 percent for export. In addition, a variety of fiscal exemptions are extended to the agricultural sector.

Although numerous studies conclude that tax incentives are not a major determinant of investment location decisions of firms, analysts and policymakers agree that foreign direct investment (FDI) plays a critical role in the growth prospects of the country. Consequently, in more recent years, the focus of fiscal incentives has shifted from "attracting investment to selected sectors" to simply "attracting investments" in the context of a highly competitive regional environment for FDI (Medalla 2002).

Studies have also raised various concerns with the Philippine fiscal incentives regime, namely: (1) high fiscal cost in terms of foregone revenues estimated to be equal to 1-2 percent of GDP[1] (Box Table 1); (2) ineffectiveness in promoting investments because of the reliance on nonperformance-based incentives; (3) distortionary impact on the economy; (4) too wide coverage of the investment priorities list; and (5) duplication of incentives from various special laws (World Bank 2000). The rationalization of fiscal incentives and tax exemptions was thus an integral part of the Comprehensive Tax Reform Package in line with the reduction in the corporate tax rate and the introduction of the NOLCO and accelerated depreciation in Tax Code. However, the bill that was originally proposed under the Tax Reform Package was not acted upon by Congress. To date, even the executive branch appears to have ambivalent views on fiscal incentives. In fact, the President's Budget for 2003 is silent about fiscal incentives.

Box Table 1. Summary of revenues waived from various fiscal incentives provisions, 1998-2000 (in billion pesos)

Statutory basis	1998	1999	2000
Tax- and duty-exempt imports under various laws	38.2	30.6	9.6
BOI-approved incentives	11.6	6.2	3.9
Tax credits	-	0.6	0.8
Subsidy availment through E.O. 93	-	3.4	2.6
Subsidy availment through the GAA	-	1.7	12.2
Conditionally-free importation under Section 10 of the Tariff and Customs Code	0.8	0.6	0.5
Economic zones incentives	-	0.7	3.7
Exemption from internal revenue taxes under various laws	-	-	4.6
Total	**50.6**	**43.8**	**37.9**
Percent of GDP	1.9	1.5	1.1

[1]The numbers shown in Box Table 1 do not include revenue foregone from the exemption of inputs to exports from taxes and duties as part of the free trade regime given to exports.

both Congress and the executive branch inasmuch as raising taxes will undeniably hurt certain sectors.

In the near term, however, a price survey of tobacco and alcoholic products should be conducted immediately to permit the reclassification of said products for excise tax purposes. Such a survey is prescribed in RA 8240 but has not been implemented to date. This move will provide temporary relief to the unmitigated erosion of revenues from excise taxes pending the legislative action on indexation.

At the same time, efforts to strengthen tax administration should be pursued even more vigorously. In particular, the administration of the VAT has been shown to be a big source of the higher tax leakage in 1998-2001 (Table 2). In principle, VAT evasion may arise from two sources: (1) the underdeclaration of sales; and/or (2) the overdeclaration of claims for input VAT. The BIR has recently launched a program that is meant to flush out firms which underdeclare their sales. Prospectively, the Bureau could also minimize the leakage from the overdeclaration of claims for input VAT through the use of industry benchmarking. In this regard, it is notable that some 45 percent of the large VAT payers were found to have exceeded their respective industry benchmark (for the ratio of the value of VAT-able inputs to value of VAT-able output) by more than 50 percent (Manasan 2002).

On a more general note, the computerization of the BIR has to be strengthened further. Better use of information technology will clearly go a long way in plugging leakages in the tax system as it provides the BIR with increased access to internal as well as external sources of information and makes way for greater automation and less discretion on the part of BIR examiners.

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